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No. 618

Supreme Court of the United States

OCTOBER TERM, 1949.

CONTINENTAL OIL COMPANY, a Delaware corporation,
~~Plaintiff~~, Petitioner,

VERSUS

H. C. JONES, COLLECTOR OF INTERNAL REVENUE,
~~Defendant~~. Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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February, 1950.

UTTERBACK TYPESETTING CO., 13 S. Walker, Oklahoma City 4, Okla.

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Plaintiff,

VERSUS

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Defendant.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

SUMMARY AND SHORT STATEMENT OF THE MATTER INVOLVED

This suit was brought by Group No. 2 Oil Corporation against H. C. Jones, Collector of Internal Revenue, for refund of overpayments of income taxes for 1940 and 1941, excess profits taxes for 1941, for interest paid on such taxes and for interest on the taxes and interest thus paid. After trial, but before judgment, Group No. 2 Oil Corporation was merged with Continental Oil Company, and the latter (petitioner here) was substituted as plaintiff. The cause was styled as above and numbered 3903 on the docket of the Court of Appeals.

The suit involved two disallowed deductions, one of

$218,047.15 representing unrecovered investments in certain surrendered oil and gas leases, a review of the decision on which is not sought; and the other of $57,328.68 representing loss on sale in 1941 of 250 shares of common stock of Reagan County Purchasing Company, Inc.* The Commissioner of Internal Revenue held there was no loss, but that the entire price received, $3,750.00, was profit, and made a net adjustment to income of $61,078.68 [R. 259, par. (f)].

Petitioner seeks hereby a review of the decision of the Court of Appeals [177 Fed. (2d) 508], which by affirming the District Court judgment sustained the disallowance of the loss and substitution of a gain on the sale of the Reagan stock. The overpayment sued for attributable to that item was $16,790.09, exclusive of interest (R. 260; Refund Claim, R. 330-333).

The taxpayer's true basis was $61,078.78 or $244.31+ per share. The facts as to the sale, the price received, and the basis were admitted in the answer (R. 27). The findings of the trial court were in accord (10 and 16, R. 36, 38).

The respondent defended on the ground that the shares sold were part of a block of 544 shares acquired by the taxpayer in its fiscal year ended March 31, 1927, of the value when received of $132,907.20 or $244.3147 per share; that the taxpayer had reported only $1.00 as the income represented thereby, and at the same time reported a loss of $39,133.37 on all its operations in the fiscal year; and, that since assessment of a deficiency for the fiscal year ending March 31, 1927, was barred by limitation, the taxpayer was estopped to claim the loss (Answer, R. 29). He urged that the same facts precluded a recovery under the

*Hereinafter referred to as "Reagan."

doctrine of "recoupment and/or set-off" (Amendment to Answer, R. 31).

In response, petitioner contended that:

(a) Sections 3770(a)(2) and 3775(a)* of the Internal Revenue Code preclude the Government from thus attempting to circumvent the applicable limitation statute.

(b) The Commissioner of Internal Revenue and his agents knew all the essential facts in time to have acted before assessment of the 1927 deficiency was barred.

(c) The taxpayer's failure to value properly the shares in its tax return for the fiscal year ending in 1927 was due to a mistake of law, the value of the shares not then having been determined, and its officers believing that they constituted income in 1924 when Reagan was organized and its stock was issued and had only a nominal value.

In 1924 Big Lake Oil Company, Texon Oil & Land Company, Group No. 1 Oil Corporation, and Group No. 2 Oil Corporation, the latter three being referred to as the "Texon Corporations", and the four of them being referred to as "Producers", and others, entered into a contract with Marland Oil Company to organize Reagan County Purchasing Company, Inc., and sell to it all oil that might be produced by the Producers in the Big Lake Field, or elsewhere in Reagan County, Texas. The contract provided for issuance of one-half of 49 per cent of the common stock in the names of the Texon Corporations, jointly, and one-half of 49 per cent in the name of Big Lake Oil Company, and that the certificates of stock should be placed in escrow to be held for the benefit of the Producers "in such number

*Revenue Act of 1928, Sections 607 and 609, respectively.

of shares or undivided interest in the whole number of shares" as should be agreed upon by them, until the preferred stock subscribed for by Marland should be retired. So long as any of the preferred stock was outstanding, no Producer was privileged to dispose of any of the common stock, except to Marland or another Producer, and that could be done only after the ultimate ownership of the 49 per cent was agreed upon (Plaintiff's Exhibit 9, R. 265-277).

On December 8, 1924, Reagan was organized and issued to the Texon Corporations, jointly, a certificate for 2,450 shares of common stock (R. 63), and to Big Lake a certificate for a like number of shares (Stip., R. 51-52). The certificates were deposited in escrow in the American National Bank of Oklahoma City (R. 286-295).

The conditions of the escrow were fulfilled by December 15, 1926, and the Producers agreed upon a division of the 49 per cent of the stock (R. 66-74). A certificate for 544 shares was then issued to Group No. 2 Oil Corporation on March 21, 1927 (R. 297).

At all times material to this controversy, the Texon Corporations were affiliated, occupied the same offices, and had the same directors, officers, managers and employees. These facts were well known to representatives of the Bureau of Internal Revenue (Revenue Agent's Reports: Group No. 1, R. 10-105; Texon of Texas, R. 80, 81; Texon of Delaware, R. 203).

In 1928 a revenue agent examined the records of all the Texon Corporations except Group No. 2 Oil Corpora-

tion (R. 220-222) and filed voluminous audit reports covering their fiscal year ending March 31, 1927, and prior years (Texon of Texas, Exhibit 1-E, R. 74, 95; Group No. 1, Exhibit 1-F, R. 96-123; Texon of Delaware, Exhibit "R", R. 199-204). The agent in charge proposed to recommend adjustments by including the Reagan shares in income for the fiscal year ending March 31, 1927, at $244.314698 per share (Texon of Texas, R. 74, 87-94), (Group No. 1 Oil Corporation, R. 96, 115-122).

Protests were filed (Exhibits 1-I and 1-J, R. 137, 141), assessment letters issued (R. 124-125, 132-133), and the tax was paid by Group No. 1 and Texon. Refund claims (R. 143-146) and supporting briefs were submitted (R. 150-153). They consistently contended that the income accrued in 1924 when the stock was issued and had no value. The refund claims were denied and litigation ensued. Texon's case was filed in the United States District Court at Fort Worth on December 12, 1938. Judgment was entered against it on October 18, 1939 (R. 182), and affirmed by the Circuit Court of Appeals (5th Cir.), on November 28, 1940 [115 Fed. (2d) 647].

Group No. 1 sued on its claim in the United States District Court at Fort Worth (R. 183-195). The printed record fails to show the filing date or disposition of the suit.* An assessment against Big Lake on the 2,450 shares it received was litigated and sustained [95 Fed. (2d) 573, *Cert.* den. 307 U. S. 639, rehearing den. 308 U. S. 632].

The complete documentary record on the stock issue was introduced in evidence for the purpose of showing that

*The controversy was compromised and the suit was dismissed.

the Producers which acquired interests in Reagan's stock at the time it was organized, and possession of certificates evidencing their divided interests in the year 1927, had what then appeared to be plausible grounds for resisting taxation of it in that year, and that their failure to report its true value in their 1927 returns resulted from a mistake of law; and, for the purpose of showing that the Commissioner of Internal Revenue and his agents in charge of collecting the tax knew all the facts concerning plaintiff's acquisition of its 544 shares long before limitations had barred an assessment.

The Commissioner of Internal Revenue, in his notice of deficiency (60-day letter) to Group No. 1, referred to the Revenue Agent's report for details of the Reagan stock acquisitions by the Producers, and made the report a part of his letter (R. 132, 137).

The trial court found that the 544 shares of Reagan stock of the value of $244.31 per share received by the taxpayer was income taxable in the fiscal year ending March 31, 1927 (Finding 10, R. 36); that it reported only $1.00 as the income represented thereby (Finding 11, R. 36), and, as a result, a net loss of $39,133.97 was shown on its return. It was further found, however, that the government agent, upon examination of the books and records of Texon and Group No. 1, "came into possession of knowledge * * * to the effect that plaintiff corporation had acquired the 544 shares of stock here involved at the same time and in the same manner as had said corporations" (*Id.* 12, R. 37).

Continuing, that Court found: "In the year 1928 the Commissioner of Internal Revenue did make an examina-

tion of the returns and books and records of plaintiff's affiliate corporations, Group No. 1 Oil Corporation and Texon Oil and Land Company. The report by these companies of the receipt of shares of Reagan County Purchasing Company stock at a nominal value of $1.00 was challenged by the Commissioner of Internal Revenue and its fair market value on receipt in 1927 determined at $244.00 per share, which was later affirmed by the Courts" (*Id.* 13, R. 37).

That Court conceded that the Commissioner was informed of the affairs of plaintiff through its return of income as filed by it and the knowledge gained by his agent in examining the records of the other corporations (*Id.* 15, R. 37), but, nevertheless, sustained the pleas of estoppel, recoupment, and setoff and denied relief (R. 40).

The Court of Appeals held that the taxpayer's mistake was not one of law, granted that it was true that the Commissioner learned the value of the Reagan stock through his examination of affiliated companies of the taxpayer, but held that he was not bound by knowledge thus gained. Disregarding applicable statutes and this Court's controlling decision in *McEachern* v. *Rose*, 302 U. S. 56, that Court declared the law to be as follows:

> "When a taxpayer received property, which constituted income to him, in a particular year and fixed the value of the property in his return for the year at less than its true value, and thereby avoided taxes, when he sells the property in a subsequent year, after the correction of the error in the return for the earlier year is barred by the statute of limitations, he may not fix the basis for determining gain or loss on

the sale at its true value and thereby obtain the benefit of a loss on the sale. He may not thus shift his position to his advantage, even though all the technical elements of estoppel are not present" (R. 345).

BASIS OF JURISDICTION

The Supreme Court has jurisdiction by *certiorari* to review the decision of the Court of Appeals in this action by virtue of the provisions of Title 28, United States Code, Section 1254(e).

Judgment was entered in the Court of Appeals on October 31, 1949 (R. 345), and a petition for rehearing filed November 19, 1949 (R. 347, 364), was denied on November 28, 1949 (R. 365). In compliance with the provisions of Title 28, United States Code, Section 2101(c), this petition is filed within ninety days thereafter.

QUESTIONS PRESENTED BY THIS PETITION

1. Whether the taxpayer, in computing gain or loss upon the sale of 250 shares of Reagan stock in 1941, was not entitled to use the correst basis of $244.31+ per share, but was bound to use a zero basis because of having reported a nominal value of $1.00 for its entire 544 shares on its return for the fiscal year ending March 31, 1927.

2. Whether, in view of the findings of the trial court that the revenue agent upon examination of the books and records of two of the taxpayer's affiliated corporations came into possession of knowledge that the taxpayer had ac-

quired its 544 shares of Reagan stock at the same time and in the same manner as had such affiliates, and that the Commissioner of Internal Revenue was informed to the same effect through the knowledge thus gained by his agent and the taxpayer's return (which showed receipt of the shares), the Court of Appeals erred in concluding, on the issue of estoppel, that the Commissioner was only charged with knowledge of facts reflected in the taxpayer's return or learned from an investigation of that return.

3. Whether the Court of Appeals erred in holding that the taxpayer's mistake in not returning the Reagan shares at their true value in 1927, was not a mistake of law rather than of fact.

4. Whether, in any event, the distinction between a taxpayer's mistake of law and a mistake of fact is of any consequence in applying the doctrine of *McEachern* v. *Rose* (302 U. S. 56), to the effect that Sections 3770(a)(2) and 3775(a) of the Internal Revenue Code preclude the Government from taking any benefit from a taxpayer's overpayment by crediting it against an unpaid tax whose collection is barred by limitation.

REASONS RELIED ON FOR ALLOWANCE OF WRIT

1. On the question of availability of estoppel, recoupment and setoff as defenses, the decision of the Court of Appeals is in conflict with,

(1) the decision of the Supreme Court in *McEachern* v. *Rose*, 302 U. S. 56;

(2) the decision of the Circuit Court of Appeals in *American Light & Traction Co.* v. *Harrison*, 142 Fed. (2d) 639 (7th Cir., 1944);

(3) the decision of the Circuit Court of Appeals in *Salvage* v. *Commissioner*, 76 Fed. (2d) 112 (2nd Cir., 1935); and the decision of the Supreme Court in the same case, *Helvering* v. *Salvage*, 297 U. S. 106; and,

(4) the decision of the Circuit Court of Appeals in *Schmidlapp* v. *Commissioner*, 96 Fed. (2d) 680 (2nd Cir., 1938).

2. On the question of whether the Commissioner was bound by knowledge gained from sources other than the taxpayer's returns and records, the decision of the Court of Appeals is in conflict with

(1) the decision of the Court of Appeals in *Ross* v. *Commissioner*, 169 Fed. (2d) 483, 495 (1st Cir., 1948); and,

(2) the decision of the Circuit Court of Appeals in *Joyce* v. *Gentsch*, 141 Fed. (2d) 891 (6th Cir., 1944).

3. On the issue of estoppel the Court of Appeals adhered to its own decisions in *Commissioner* v. *Farren*, 82 Fed. (2d) 141, 143 (1936), and prior cases, although *certiorari* was granted in the *Farren* case May 25, 1936 (298 U. S. 653), and was dismissed, *per stipulation of Counsel*, on October 26, 1936 (299 U. S. 617). The same reasons which impelled the granting of the writ in that case are present here.

WHEREFORE, petitioner prays that a *writ of certiorari* issue to review the decision of the Court of Appeals in this cause.

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BRIEF IN SUPPORT OF PETITION

OPINION BELOW

The opinion of the Court of Appeals is reported in 177 Fed. (2d) 508.

JURISDICTION

The grounds on which Jurisdiction of this Court is invoked are stated on page 8 of the Petition.

STATEMENT OF THE CASE

The facts have been outlined in the petition under the head of "Summary and Short Statement of the Matter Involved."

STATUTES INVOLVED

The statutes involved are copied in the appendix.

They are: Internal Revenue Code, Sections 275(a), 3770(a)(2), and 3775(a).

ASSIGNMENTS OF ERROR

1. The decision of the Court of Appeals is erroneous and in conflict with the decisions of this Court and of other courts of appeal on the question of estoppel, recoupment or setoff as a defense.

2. The decision of the Court of Appeals is erroneous and in conflict with the decisions of other courts of appeal on the question of the binding effect on the Commissioner of Internal Revenue of knowledge gained from sources other than the taxpayer's return and records.

ARGUMENT

(1).

In *McEachern* v. *Rose,* 302 U. S. 56, the taxpayer's decedent had sold shares of corporate stock in 1924 at a profit of $295,000.00, payable in ten equal annual installments. After his death in 1928, the taxpayer (administrator) continued from 1929 to 1931 to pay income tax on the installments, whereas he should have reported for 1928 the capital gain included in the value of the unpaid installments at the time of the decedent's death. This Court said that the "returns were erroneous in point of fact and law, as the petitioner sold no shares of stock in any of those years." After assessment of the tax for 1928 was barred, the taxpayer sought to recover the overpayments for 1929 to 1931, inclusive. The Government contended that he was estopped, since the overpayments were less than the tax which should have been assessed in 1928. The Supreme Court assumed that equitable principles would have precluded a recovery in the absence of any statutory provision requiring a different result, but concluded that Congress has set limits to the extent to which courts might otherwise go in curtailing a recovery of overpayments because of a taxpayer's failure to pay other taxes which might have been, but were not, assessed against him, and that Sections 607 and 609(a), Revenue Act of 1928, preclude the Govern-

ment from taking any benefit from a taxpayer's overpayment by crediting it against an unpaid tax whose collection has been barred by limitation. 302 U. S. 59, 60.

In *American Light & Traction Co.* v. *Harrison,* 142 Fed. (2d) 639 (7th Cir., 1944), a subsidiary of the taxpayer, in an exchange of common stock of another corporation for debentures of still another corporation, realized a taxable profit of $2,851,504.00, which the taxpayer, in its consolidated return for 1928, did not report because it believed the transaction was tax-free. The law was later settled to the contrary. During the years 1930 and 1931, the subsidiary sold some of the debentures at their face value. Hence no gain was realized thereon. In 1933 it sold the rest, and the taxpayer erroneously included in its consolidated return taxable income on account of the last sale in the sum of $1,731,403.76. It sought a refund, which was rejected, and suit was brought against the collector. The collector contended that he was entitled in equity to recoup against the taxpayer's claim for overpayment in 1933 the taxes which should have been paid on the subsidiary's profits on the exchange of stock for debentures in 1928. The Circuit Court of Appeals said:

> "Section 607 of the Revenue Act of 1928, 45 Stat. 791, 874, 26 U. S. C. A. Int. Rev. Code, §3770(a) (2), which is significantly entitled 'Effect of Expiration of Period of Limitation Against United States,' provides that any payment of a tax after the expiration of the applicable period of limitation shall be considered an overpayment and directs that it be '* * * credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim.' Under this section, any payment of the barred de-

> ficiency for 1928 would constitute an overpayment, the refund of which would be mandatory. Section 609(a) provides that 'Any credit against a liability in respect of any taxable year shall be void if any payment in respect of such liability would be considered an overpayment under Section 607.' 45 Stat. 875, 26 U. S. C. A. Int. Rev. Code, §3775(a). Since the payment of the barred deficiency for 1928 would constitute an overpayment under §607, it necessarily follows that any credit of the 1933 overpayment against the barred deficiency would be void under §609(a). In the light of these provisions, the only possible conclusion is to affirm the District Court's judgment for the plaintiff. Any other result would effect a judicial repeal of the Act of Congress."

In *Salvage* v. *Commissioner,* (2nd Cir., 1935), 76 Fed. (2d) 112, the taxpayer purchased stock in 1922 at a bargain and failed to report as income the profit represented by the difference between the price paid and the value of the stock. In computing his gain on the sale of the stock in 1929 he used the correct basis, *i. e.*, the value of the stock when it was acquired. The statute of limitations had run on collection of the tax that would have been due for 1922 had the profit been reported. The Commissioner pleaded estoppel. The Circuit Court of Appeals sustained the taxpayer's right to use the true basis of the shares upon the sale of them. This Court affirmed the decision holding that the issue of estoppel was not raised and should not have been passed upon by the court below, but, further, that "*the facts disclosed give it no support.*"

In *Schmidlapp* v. *Commissioner* (2nd Cir., 1938), 96 Fed. (2d) 680, the taxpayer, in 1929, sold certain shares of stock, which he had bought at various times, at a profit

which he did not report in his return for that year, on the theory that he would use proceeds of first sales to amortize the entire purchase price and treat proceeds of later sales as profit. In 1932 he sold his remaining shares and followed the same method, that is, he subtracted the proceeds of the 1932 sales from what was left unamortized of the original purchase price and deducted the balance as a loss. The Commissioner, for other reasons, disallowed his entire deduction, but the Board reversed and reinstated the deduction, though only for the amount claimed. A deficiency resulted which the taxpayer could expunge only if allowed to calculate his loss for 1932 by the "first in, first out" method. Had he applied that method in 1929, a taxable gain would have resulted nearly as great as the deduction claimed. It was too late to assess any tax for 1929. It was contended that he could not disavow his first choice as to the method of calculating gain or loss and altogether avoid a tax which in 1929 he professed only to defer. The Circuit Court granted there was much justice in the argument, and that it would have been particularly strong if the taxpayer had been seeking to get back what he had paid, but concluded:

> "Yet even then, *McEachern* v. *Rose,* 302 U. S. 56, would stand in the way, since under section 609(a) of Revenue Act of 1928, the credit of any sums due in the later year would be 'void' against an assessment, payment of which would have to be refunded under section 607 of the Revenue Act of 1928. * * * The doctrines of a court of equity are irrelevant to the levying of taxes; Congress alone lays down the conditions and has not attempted to bring other years into hotch-pot. Quite other considerations decide

whether a sum, once paid as a tax, shall be recovered; the mere payment creates no obligation to return it, the taxpayer makes it at the peril of showing that in common justice it ought not to be retained. *Farren* v. *Commissioner,* 10 Cir., 82 Fed. 2d 141, is not to the contrary; it only held that, since the taxpayers failed to prove the cost of the shares sold, they must be content to have the whole proceeds taxed as profit. On the other hand, *Salvage* v. *Helvering,* 2 Cir., 76 F. 2d 112; *Id.,* 297 U. S. 106, 56 S. Ct. 375, 80 L. Ed. 511, cannot be reconciled with the notion that the validity of a deduction in a later year shall be measured by recourse to the assessments of earlier years."

The problem of allocating income to the right year in cases involving escrows or conditional deliveries is rarely an easy one. The taxpayer and other producers which held the Reagan stock are not to be censured, therefore, for having guessed wrong in contending that it constituted income in 1924, when it had only a nominal value, and not in 1927, when it had greatly enhanced in value. And, too, since they had paid nothing for the stock, their position was similar to that of the taxpayer in the *Salvage* case who failed to report the profit on a bargain purchase. It is submitted that the error was not a mistake of fact but merely one of law.

It is to be remembered that the taxpayer, as well as its affiliates, did nothing to conceal receipt of the income; that they reported receipt of the shares in their 1927 returns.

The Commissioner had the taxpayer's 1927 return and, as found by the trial court, he learned that it had received the stock entered thereon at the same time and in the same

manner as the taxpayer's affiliates had received their shares, which were the subject of audits and assessments in 1928, and ultimately of suits. He knew of the circumstances in time to have taken appropriate action against the taxpayer before assessment of the 1927 tax was barred. These facts and findings of the trial court the Court of Appeals should have accepted as binding on it, but that court, nevertheless, recognized that "all the technical elements of estoppel are not present" (R. 345, line 10).

If "all the elements of estoppel are not present", then there is no estoppel, and characterizing the absent element as "technical" does not create one. The Court of Appeals, without classifying the theory it applied, stated in its conclusion quoted at pages 7-8 of the petition a doubtful case for application of the doctrines of recoupment or setoff, even in the absence of the statutes which were held to be controlling in *McEachern* v. *Rose, American Light and Traction Co.* v. *Harrison,* and *Schmidlapp* v. *Commissioner, supra.*

(2).

JUSTICE FRANKFURTER'S opinion in *Ross* v. *Commissioner of Internal Revenue* (1st Cir., 1948), 169 Fed. (2d) 483, covers every phase of the controversy presented by this petition. Among the questions discussed was the point raised by the Commissioner that the taxpayer had failed to report income (salary installments constructively received) in the years received. The evidence showed, though less clearly than here, that the Commissioner knew, or should have known, the facts from other sources, particularly the books and records of the taxpayer's employer.

The Court granted that where a party is under a duty to disclose the existence of a fact and does not do so, his silence amounts to a statement that the fact does not exist, and referred to the cases so holding; but it then continued as follows:

> "They do not qualify the proposition that a party may not successfully claim reliance on a misrepresentation when he knew the truth, nor probably even when he ought to have known the truth. *Joyce* v. *Gentsch*, 6 Cir., 1944, 141 F. 2d 891; *Helvering* v. *Schine Chain Theatres, Inc.*, 2 Cir., 1941, 121 F. 2d 948; *S. Rossin & Sons, Inc.* v. *Commissioner*, 2 Cir., 1940, 113 F. 2d 652; *Hull* v. *Commissioner*, 4 Cir., 1937, 87 F. 2d 260; *Helvering* v. *Brooklyn City R. Co.*, 2 Cir., 1934, 72 F. 2d 274; see 10 Mertens, *supra*, §60.03. In the *Brooklyn City R. Co.* case, the Commissioner's claim of estoppel was defeated because the facts which he claimed to be misrepresented were available at all times on the books of the taxpayer. The record before us contains several references to the likelihood that respondent knew, or should have known, the true facts surrounding the accrual of petitioner's salaries and the unrestricted availability of these salaries after April, 1932. For example, in 1935 the Commissioner began to contest Chase's tax treatment of accrued salaries for 1932 and 1933, and thus apparently learned of the facts in question before the taxable year 1932 was barred as to Ross. Moreover, E. M. Chase Company always deducted the entire amount of the salaries of Chase and Ross on its corporate return, and the discrepancy between the individual returns and the corporate return was always evident, whether or not it registered on the official consciousness. And, as in the *Brooklyn City R. Co.* case, the accrued salary accounts of Chase and Ross were always disclosed on the financial statements of the company. A letter

from the Internal Revenue Service to the company, dated December 29, 1933, shows indisputably that respondent knew of the accrued salaries and of petitioner's tax treatment of them. This letter, written when the taxable year 1932 was still open, reveals full knowledge on the part of respondent of the operations of the company, including the gradual retirement of Chase's preferred stock. Under these circumstances respondent was justified in relying on Ross' returns for no more than the taxpayer's honest understanding of his liabilities, and it was respondent's duty to make up his own mind as to the taxability of the accrued salaries. *Joyce* v. *Gentsch, supra; Commissioner* v. *Saltonstall*, 1 Cir., 1941, 124 F. 2d 110; *Helvering* v. *Schine Chain Theatres, Inc., supra.*

* * * * * * * *

"(20) A mere failure to report income is not a representation that such income has in fact not been received. Inasmuch as the tax incidence of so many transactions is as doubtful as it is, from the mere failure to report income no more significant inference should be drawn than *the taxpayer's own interpretation of the law.* And it seems settled that estoppel cannot be predicated upon a mere statement of law or silence resulting from an error of law. *Commissioner* v. *American Light & Traction Co.*, 7 Cir., 1942, 125 F. 2d 365; *Commissioner* v. *Union Pacific R. Co.*, 2 Cir., 1936, 86 F. 2d 637; *United States* v. *Du Pont*, D. C. Del., 1942, 47 F. Supp. 894; *Sugar Creek Coal & Mining Co.*, 1934, 31 B. T. A. 344; *Tide Water Oil Company*, 1934, 29 B. T. A. 1208 (1934).

"(21) Of course this court may not make findings as to the existence or lack of existence of facts sufficient to raise an estoppel. But even if the Tax Court on reconsideration of this case should find in the record justifiable reliance by the respondent on the

petitioner's returns, it is our view that *in the absence of either deliberate or unintentional misrepresentation of facts there can be no estoppel.* It may be noted that if we were to hold that mere failure to report income results in estoppel and therefore in effect tolls the statute of limitations, we would be rendering virtually meaningless §275(c) of the Internal Revenue Code, 26 U. S. C. A. Int. Rev. Code, §275(c), which provides, 'If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed * * * at any time within 5 years after the return was filed' " (pp. 495, 496).

Although the facts are not similar, the principles declared in the decision of *Joyce* v. *Gentsch* (6th Cir., 1944), 141 Fed. (2d) 891, are applicable here. There, after a settlement of taxpayer's liabilities for 1934 had been accepted by the Government without a formal closing agreement, the taxpayer filed a claim for the same year because of his failure to deduct a loss on certain corporate stock which had become worthless in that year. He had claimed the same loss in 1935, but withdrew that claim when he filed his 1934 claim. The Government had determined that the stock became worthless in 1937. When the claim for refund was filed, further assessments for 1934 were barred. The Circuit Court of Appeals, as well as the District Court, noted the practical difficulty of determining when, for income tax purposes, stocks have become worthless (p. 894, col. 1). After pointing out that for a sufficient time before the statute of limitations had run, the Commissioner possessed all essential information as to the affairs of the corporations which had issued the stocks upon which to

base an opinion as to when the stocks became worthless, the Circuit Court of Appeals continued:

> "In these circumstances, if he allowed the statute of limitations to run without taking appropriate action upon the strength of the information which he possessed, it is now too late for him to complain. See *Louis Werner Saw Mill Co.* v. *Helvering*, 68 App. D. C. 267, 96 F. 2d 539, 543, *supra*. As was well said in *Hull* v. *Commissioner of Internal Revenue*, 4 Cir., 87 F. 2d 260, 262, *supra*: 'Estoppel is an affirmative defense, and the burden is upon the party asserting it to establish both the facts necessary to support it and the fairness of its application, and a party even knowing the facts, or in a position to know them, cannot claim the benefit of estoppel.' It was noted in *Helvering* v. *Schine Chain Theatres, Inc.*, 2 Cir., 121 F. 2d 948, 950, *supra*, that if all the facts were available to the Commissioner, he was justified in relying upon the tax return for no more than the taxpayer's 'honest understanding of his liabilities,' and that if the Commissioner 'wished to avoid the running of the statute, he must make up his mind for himself' " (pp. 896, 897).

CONCLUSION

If the decision below is permitted to stand, it will create confusion on the issue of estoppel as a defense in tax cases. Unless its error is corrected, the Court of Appeals for the Tenth Circuit may be expected to follow its own decision in the *Farren* case, which nowhere else, except perhaps in the Fifth Circuit, is recognized as correct.

On the question of the binding effect on the Commissioner of knowledge gained by him from sources other than

the taxpayer's own return and records, the conflict between the decision in the case at bar and that of the Court of Appeals for the First Circuit in *Ross* v. *Commissioner* is obvious. CHIEF JUDGE PHILLIPS, speaking for the Court of Appeals in the Tenth Circuit, asserts that the Commissioner is not bound by knowledge thus gained. JUSTICE FRANKFURTER, speaking as Circuit Justice in the *Ross* case, said just as emphatically that the Commissioner *is* bound by knowledge thus gained. It is therefore urged that this Petition for Certiorari should be granted.

Respectfully submitted,

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February, 1950.

APPENDIX

INTERNAL REVENUE CODE SECTIONS

Section 275. *Period of limitation upon assessment and collection.*

(a) *General rule.* The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

Section 3770. *Authority to make abatements, credits, and refunds.*

(a) *To taxpayers*

* * * * * * * *

(2) *Assessments and collections after limitation period.* Any tax (or any interest, penalty, additional amount, or addition to such tax) assessed or paid after the expiration of the period of limitation properly applicable thereto shall be considered an overpayment and shall be credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim.[1]

Section 3775. *Credits after periods of limitation.*

(a) *Period against United States.* Any credit against a liability in respect of any taxable year shall be void if any payment in respect of such liability would be considered an overpayment under Section 3770(a) (2).[2]

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[1]From Sec. 607 Revenue Act 1928.

[2]From Sec. 609 Revenue Act 1928.

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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 618

CONTINENTAL OIL COMPANY, A DELAWARE CORPORATION, PETITIONER

v.

H. C. JONES, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the District Court (R. 33-40) are reported at 83 F. Supp. 609. The opinion of the Court of Appeals (R. 337-345) is reported at 177 F. 2d 508.

JURISDICTION

The judgment of the Court of Appeals was entered October 31, 1949 (R. 345), and petition for

rehearing (R. 347-364) was denied November 28, 1949 (R. 365). The petition for a writ of certiorari was filed on February 23, 1950. The jurisdiction of this Court rests upon 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

Whether the court below erred in holding that taxpayer, which in 1927 received stock in Reagan County Purchasing Company having an actual fair market value of $244.31 a share and reported it in 1927 for income tax purposes as having a nominal value of $1, may not in 1941, upon sale of a portion of the stock, use $244.31 a share as its cost basis in computing gain or loss upon the sale.

STATEMENT

This case was instituted as a suit for refund of taxes and interest paid by Group No. 2 Oil Corporation (hereinafter called the "taxpayer") on deficiency assessments of income taxes for the years 1940 and 1941 and of excess profits tax for the year 1941. (R. 337.) Taxpayer was thereafter merged with petitioner, the Continental Oil Company, and that company was substituted as plaintiff after the trial but before judgment. (R. 337.) The case in the District Court and court below involved two issues, both of which were decided against petitioner by both courts. (R. 39-40, 341-345.) Petitioner seeks review of the decision below on only one of those issues. (Pet. 1-2.)

The facts found by the District Court pertinent to the one issue on which review is sought by this Court may be summarized as follows:

Taxpayer was incorporated on October 22, 1921, under the laws of the State of Delaware, and was authorized to issue 485,000 shares of stock of a par value of $1 a share. Its entire capital stock was subscribed by, and issued to, Texon Oil & Land Company, a Delaware corporation, for a consideration. (R. 33.)

In 1927 taxpayer received 544 shares of stock in Reagan County Purchasing Company, Inc. (hereinafter called "Reagan"). Reagan stock had been issued to taxpayer, Big Lake Oil Company, Texon Oil and Gas Company, and Group No. 1 Oil Corporation in connection with an agreement entered into in 1924 with the Marland Oil Company, but the stock had been placed in escrow when issued and was to be delivered upon fulfillment of certain conditions. The conditions were carried out and the stock was distributed in 1927. (R. 36.)

The 544 shares of Reagan stock were received by taxpayer in its fiscal year ended March 31, 1927. The shares had a value of $244.31 a share, which constituted income taxable to taxpayer in that fiscal year. Instead of reporting the stock at a value of $244.31 a share, taxpayer reported it at $1 a share. (R. 36.)

As a result of reporting the shares at a value of $1 a share, taxpayer's 1927 return of income showed

a net loss of $39,133.97. Because the return showed that loss, the Commissioner made no examination of the return or of taxpayer's books and records for 1927. Nor was he officially or pointedly informed of the matter by taxpayer. However, the Government agent who examined the books and record of the other two named companies came into possession of knowledge from the books and records of those corporations to the effect that taxpayer had acquired the 544 shares of Reagan stock at the same time and in the same manner as had those two companies. (R. 36-37.)

In 1928 the Commissioner made an examination of the returns and books and records of taxpayer's affiliate corporations, the Texon Oil and Land Company and Group No. 1 Oil Corporation. The Commissioner challenged the report of these companies of receipt of Reagan stock at a nominal value of $1 a share and determined its fair market value on receipt in 1927 at $244 a share, which determination was later affirmed by the courts. Taxpayer did not inform the Commissioner that the same situation existed with respect to its income for 1927, nor did it in any manner advise the Commissioner that it erred in reporting the stock at a nominal value of $1 a share in 1927 until the filing of its return of income in 1941. (R. 37.)

No tax deficiency was assessed against taxpayer for the fiscal year ended March 31, 1927. The revenue agent who made the examination and audit of

the books and records of Texon Oil and Land Company and Group No. 1 Oil Corporation did not make an examination of, or report on, the income tax return and the books and records of taxpayer for the fiscal year ended March 31, 1927, and the Commissioner was not informed of taxpayer's affairs other than through its return of income as filed by it and the knowledge gained by his agent in examining the other two above-named corporations. (R. 37.)

In its taxable year 1941 taxpayer sold 250 shares of the Reagan stock which it had received in 1927. The sale price was $3,750. Taxpayer reported a loss thereon in its return for 1941 of $57,328.68, arrived at by using as a basis, $244.31 a share or $61,078.68. (R. 38.)

Upon and after an examination and audit of taxpayer's 1941 tax return and its books and records, the Commissioner held that taxpayer's basis for the shares was zero and disallowed the deduction of $57,328.68 claimed by taxpayer as loss upon the sale of the 250 shares. (R. 38.)

Taxpayer has failed to establish by a fair preponderance of the evidence that it suffered a net loss during 1941 and that it did not in 1941 earn normal and surtax net income in the amount of $54,968.06 and excess profits tax net income in the amount of $60,547.83 as determined by the Commissioner. (R. 38.)

By its conduct and treatment of the Reagan stock received by it in 1927, taxpayer is estopped from questioning the treatment accorded the stock in his final determination of tax liability for the year 1941. In any event the Commissioner is entitle to recoupment and set-off for the full amount of the tax which he would have been entitled to exact from taxpayer in 1927 had taxpayer properly reported and paid a tax on the stock in 1927. (R. 39.)

The District Court's conclusion of law as to the Reagan stock was as follows (R. 40):

> 5. The gain to plaintiff on receipt of the shares of stock in Reagan County Purchasing Company, Inc. in 1927 was $244.31 per share. This gain was not reported in its return of income for said year and no tax was paid thereon. Upon the sale in 1941 of 250 shares of stock in said company by plaintiff, the Commissioner of Internal Revenue on account of the prior action of the plaintiff in 1927, properly determined that a zero basis should be used by plaintiff in determining the gain on the sale in 1941. By reason of its said action in the prior year, plaintiff is precluded under the doctrines of estoppel and recoupment from using the correct cost basis of such shares in order to establish and claim a loss for income tax purposes upon the sale thereof in 1941.

Affirmance of the District Court's decision on appeal was based upon what may conveniently be termed "quasi-estoppel". (R. 344-345.)

ARGUMENT

Petitioner's grounds for the granting of a writ of certiorari consist principally of asserted conflicts with six different decisions. (Pet. 9-10.) The asserted conflicts are superficial, we submit, the differences in result in the cases being attributable to the differences in facts.

1. The decision below is not in conflict with *McEachern* v. *Rose*, 302 U. S. 56. In that case the taxpayer had made overpayments of tax for the years 1929 through 1931 and the Government, on the theory of recoupment, sought to credit such overpayments on the taxpayer's unpaid tax for 1928 the collection of which was barred by the statute of limitations. It was held that recoupment was precluded by Sections 607(a)(2) and 609(a) of the Revenue Act of 1928, c. 852, 45 Stat. 791, which are similar to Sections 3770(a)(2) and 3775(a) of the Internal Revenue Code (26 U.S.C. 1946 ed., Secs. 3770, 3775), relied upon by petitioner and quoted in the appendix to its petition. In the present case no admitted overpayment is involved. The decision below does not rest on the right of recoupment. The court below has simply held that, since the taxpayer in 1927 reported the Reagan stock as income at a value of $1, it may not change its position and use a higher basis for determining gain or loss on the sale of the stock in 1941. The question is whether this is a proper defense in petitioner's suit for refund

of the 1941 deficiency determined by the Commissioner and paid by taxpayer. The *McEachern* case does not purport to decide such an issue. Moreover, according to the Court's decision in *Stone* v. *White,* 301 U. S. 532, 538, the statutes applied in the *McEachern* case do "not override a defense based on the estoppel of the taxpayer" and, as the Court stated in the *McEachern* case itself (p. 59), equitable principles control in the absence of any applicable statutory provision.[1]

2. Similarly, the decision below is not in conflict with *American Light & Traction Co.* v. *Harrison,* 142 F. 2d 639 (C.A. 7th). As the opinion in that case states (p. 641), it was there conceded that a previous decision of the same court had settled the question of estoppel against the Government. The case involved recoupment, the taxpayer having made an admitted overpayment for 1933 which the Government sought to credit against the tax which the taxpayer should have paid for 1928.

3. In *Salvage* v. *Commissioner,* 76 F. 2d 112 (C.A. 2d), it was held that estoppel does not arise

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[1] Although the decision below was not based upon recoupment, we do not concede that the doctrine of recoupment is not applicable in the present case. *Rothensies* v. *Electric Battery Co.,* 329 U. S. 296, seems to hold that, while recoupment does not allow one transaction to be offset against another, a transaction which is made the subject of suit by a taxpayer may be examined in all its aspects and judgment rendered that does justice in view of the one transaction as a whole.

from an innocent mistake of law. This Court's decision in the same case (*Helvering* v. *Salvage,* 297 U. S. 106) stated that the defense of estoppel was not before the Board of Tax Appeals (now the Tax Court) and for that reason the Court of Appeals should have passed the point. The Court added, "Furthermore, the facts disclosed give it no support" (p. 109). Decision in the present case was based upon taxpayer's action in reporting the Reagan stock in 1927 at a nominal value of $1 when it actually had a value at that time of $244.31 a share. (R. 344-345.) The court below specifically pointed out that, if this action was due to a mistake, it was a mistake of fact and not of law. (R. 344.) The decision below does not purport to hold that estoppel may arise from an innocent mistake of law and, accordingly, the asserted conflict with the decisions in the *Salvage* case is nonexistent.[2]

4. In *Schmidlapp* v. *Commissioner,* 96 F. 2d 680 (C.A. 2d), the taxpayer had the option of calculating gain or loss on the sale of stock in either of two ways. He had purchased shares of Chase National Bank stock and sold some of them in 1929, when he

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[2] Nor is there any basis for petitioner's assertion (Br. 17) that taxpayer's error was merely a mistake of law. The assertion is based on a suggestion that taxpayer should not be censured "for having guessed wrong in contending that it [the Reagan stock] constituted income in 1924, when it had only a nominal value, and not in 1927, when it had greatly enhanced in value". (Br. 17) The record does not show that taxpayer contended that the stock constituted income in 1924. On the contrary, it was in 1927, not 1924, that taxpayer reported the stock *as income* at a nominal value.

used one method of reporting his gain or loss. In 1932, when he sold the remainder, he used the other method and it was held that his choice as to the 1929 transaction did not preclude him from changing to the other method as to the 1932 transaction. The case is therefore factually distinguishable from the present case. No direct conflict with the instant decision is apparent from the opinion, which, however, is not entirely clear. The case was decided by the Court of Appeals for the Second Circuit and that court does not deny that estoppel may be available to the Government in a proper case. See *Helvering* v. *Schine Chain Theatres,* 121 F. 2d 948 (C.A. 2d).

5. In *Ross* v. *Commissioner,* 169 F. 2d 483 (C.A. 1st), the taxpayer had constructively received income in 1927 to 1932, consisting of accrued salaries, which he did not report and it was held that such income could not be taxed to him in 1939 because, as a matter of law, the income had been received, and was taxable, in the previous years of constructive receipt. The subject of estoppel in tax cases was discussed and the court's holdings in that connection were as follows: (1) That "in the absence of misstatement of fact, intentional or otherwise" (p. 496), the taxpayer was not estopped from asserting that the income was taxable only in the years in which constructively received; (2) that a mere failure to report income is not a representation that such income has in fact not been received;

and (3) that, since the Commissioner had full knowledge of the accrued salaries, he was justified in relying on the taxpayer's returns for no more than the taxpayer's honest understanding of his liabilities and it was the Commissioner's duty to make up his mind as to the taxability of the accrued salaries.

As the decision reflects (pp. 493-494), the conflict in decisions in respect of the application of the estoppel doctrine in tax cases results principally from the application of the doctrine by some courts in cases where reliance is not based upon any misstatement of fact, innocent or otherwise. This is not such a case and the decision below definitely does not conflict with the first two of the above-numbered holdings in the *Ross* case. As already stated (*supra,* p. 9), the court below pointed out that if taxpayer's action in listing the Reagan stock as income at a value of $1 was a mistake, it was a mistake of fact and not of law, and it was that type of mistake to which the court below held estoppel applicable.

Petitioner may be correct in asserting (Pet. 10) that the decision below is in conflict with the *Ross* decision on the question whether the Commissioner is bound by knowledge gained from sources other than the taxpayer's returns and records, but we believe the conflict, if it exists, is not such as to justify the granting of the instant petition for a writ of

certiorari. As to the effect of the Commissioner's knowledge, the court below held (R. 344):

> It is true, the Commissioner learned the value of the Reagan stock through his investigation of affiliated companies of the taxpayer, but the Commissioner was only charged with knowledge of the facts reflected in the taxpayer's return or facts he learned from an investigation of that return. To hold otherwise would place an insuperable burden on the Commissioner.

The *Ross* decision held in effect that the Commissioner was bound by knowledge obtained from other sources, but the evidence of the Commissioner's knowledge was used only to support the conclusions that the Commissioner was justified in relying upon the taxpayer's returns for no more than the taxpayer's honest understanding of his liabilities and that it was the Commissioner's duty to make up his own mind as to the taxability of the accrued salaries. The *Ross* opinion also stated that from the mere failure to report income no more significant inference should be drawn than the taxpayer's own interpretation of the law (p. 496). In other words, the *Ross* case was regarded as involving a mistake of law on the part of the taxpayer of which the Commissioner had knowledge. To reiterate, in the present case it was an error of fact and not of law—taxpayer's misrepresentation of the value of the Reagan stock, not the failure to report the stock as income—on which the court below predicated its

application of the estoppel doctrine. It is doubtful that the statements in the *Ross* opinion as to the Commissioner's knowledge were intended to cover such a situation, especially since the ultimate conclusion in that case as to estoppel (p. 496) was simply that estoppel is inapplicable in the absence of misstatement of fact, intentional or otherwise. In any event, the difference in the facts of the two cases is such as to preclude the existence of a square conflict.

6. In *Joyce* v. *Gentsch,* 141 F. 2d 891 (C.A. 6th), the taxpayer in 1935 reported a loss for worthless stock of two companies, the loss was disallowed by the Commissioner, and the taxpayer subsequently sought a refund for 1934 on the ground that the same stocks had become worthless in 1934. The case is like *Ross* v. *Commissioner,* 169 F. 2d 483 (C.A. 1st), in that it did not involve a misrepresentation of fact. Nor are the statements in the opinion with respect to the Commissioner's knowledge inconsistent with the statements of the court below in the same connection. The *Joyce* opinion states that the Commissioner possessed all essential information upon which to base an opinion as to when the stocks became worthless, but the Commissioner's knowledge in this respect was related to the taxpayer's returns, for in 1937, when taxpayer's 1934 tax was recomputed under a proposed settlement, the taxpayer's claim for deduction of the stock losses in 1935 was pending before the Commissioner. There

would therefore appear to be no conflict between the decision below and the *Joyce* decision.

7. In *Commissioner* v. *Farren,* 82 F. 2d 141 (C.A. 10th), certiorari granted, 298 U. S. 653, certiorari dismissed, 299 U. S. 617, where the taxpayers in 1918 received shares of stock as compensation for services and did not report the stock as income because they honestly believed no return was necessary until the stock was sold, it was held that the taxpayers were required to use a zero basis in determining gain on the sale of the stock in 1926. That case, unlike the present one, involved a mistake of law on the part of the taxpayers.

CONCLUSION

The decision below is correct and there is no clear conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

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MARCH, 1950.

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No. 618

Supreme Court of the United States

OCTOBER TERM, 1949

CONTINENTAL OIL COMPANY, a Delaware Corporation,
Petitioner,

VERSUS

H. C. JONES, Collector of Internal Revenue,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

It may serve to narrow the limits of needful discussion to point out, first, that Respondent does not challenge the proposition that the Commissioner of Internal Revenue is and should be bound by all knowledge possessed by him with respect to a taxpayer's liabilities regardless of the source of such knowledge. This is the subject of the Second Reason for Allowance of the Writ and Second Assignment of Error in the Petition for Certiorari.

Conflict with Ross v. Commissioner, 169 Fed. 2d 483 (1 Cir. 1948)

It is conceded: "Petitioner may be correct in asserting (Pet. 10) that the decision below is in conflict with the *Ross* decision on the question whether the Commissioner

is bound by knowledge gained from sources other than the taxpayer's returns and records * * *." (Respondent's Brief 11). It is further stated: "The *Ross* decision held in effect that the Commissioner was bound by knowledge obtained from other sources * * *." (Respondent's Brief 12).

Perfect ingenuousness would have compelled omission of the words "in effect" from the clause last quoted, but the significance of the statement on the question of conflict is not lost by its having been too cautiously phrased.

Respondent argues, however, that the conflict with the *Ross* case "is not such as to justify the granting of the instant petition for writ of certiorari" (Respondent's Brief 11) because, says the Respondent, "the evidence of the Commissioner's knowledge was used *only* to support the conclusions that the Commissioner was justified in relying upon the taxpayer's returns for no more than the taxpayer's honest understanding of his liabilities and that it was the Commissioner's duty to make up his own mind as to taxability of accrued salaries." (Respondent's Brief 12). (Emphasis supplied). The use of evidence of knowledge, from whatever source, may not be thus limited. If found to be true, as in the case here, its use is to destroy completely the defense of estoppel.

The Court of Appeals in deciding the *Ross* case would not have bothered to reach the conclusions referred to if they had been but an end within themselves, having no bearing upon the ultimate issue, estoppel. Surely, in saying that the Commissioner was bound by whatever knowledge he had acquired, regardless of its source, and that knowing the facts he was bound to make his own decisions, the

Court was not merely instructing the Commissioner as to his duties. Those observations were but logical steps leading to the conclusion that in the state of the record there under review estoppel was not proved. The Court held: (1) The Commissioner is bound by facts known to him, no matter what the source of his information; (2) Where he knows the truth concerning an item of income, he cannot close his eyes to it and rely on a taxpayer's return which may contain misrepresentations or no information at all with respect to such item, and, having knowledge of the facts, it is his duty to make up his own mind as to the liabilities of the taxpayer; and (3) If he does not seasonably do so and follow his decision by appropriate action, he cannot avoid the statute of limitations by pleading estoppel.

Respondent argues now that the failure on the part of the taxpayer to return income was treated in the *Ross* case as a mistake of law. The Commissioner in that case contended just as vigorously as does the Respondent here that the mistake was one of fact—that the taxpayer had made a misstatement of fact (169 Fed. 2d 495). It is a fairer over-all appraisal of that opinion to say that the Court ruled out the estoppel defense whether the taxpayer's mistake be considered as one of fact or as one of law. The important thing was that the Commissioner knew that the income had not been reported for the years in which it was received, or at least he had failed to discharge the burden of proving that he had not learned of such fact from sources *aliunde* the return.

For the purpose of showing the effect of knowledge

on the part of the Commissioner on his plea of estoppel, the Court accepted the Commissioner's contention that the failure to return the shares amounted to a misrepresentation of fact, and referred to the circumstance that the Commissioner relied on *Crane* v. *Commissioner*, 68 Fed. 2d 640 (1 Cir. 1934). In that connection, the Court did not say that such a mistake is one of law rather than of fact, but pointed out that the *Crane* and *Countway** cases were not controlling because "knowledge of the *facts* not disclosed was not imputed to the Government" (Italics supplied).

Where knowledge of the truth is possessed by or imputed to a party pleading estoppel, it can make no difference on that issue whether the alleged misrepresentations are of fact or of law, or a mixture of both.

Indeed, questions of imputed knowledge and reliance on the opposite party's statements can arise in such cases only when the statements are factual, for, as the court said in the *Ross* case, "it seems settled that estoppel cannot be predicated upon a mere statement of law or silence resulting from an error of law" (p. 496).

It is evident that Respondent's confusion on the subject results from not distinguishing between the failure of the taxpayer in the *Ross* case to report the *fact* of receipt of income and his mistake of law which induced his failure to report that fact; and, likewise, his failure in the case at bar to distinguish between the fact of the return of the shares at $1.00 and the taxpayer's mistake of law which induced it to thus return the shares.

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*Countway v. Commissioner, 127 Fed. 2d 69 (1 Cir. 1942).

The Court's disposition of the estoppel contention in the *Ross* case assumed the possibility of misrepresentations of fact as well as of law, and, that, on remand, the tax court might or might not find that the Commissioner knew the facts from sources other than the taxpayer's returns and records. Two rules laid down covered every possible set of circumstances that might be found by the tax court. There could be no estoppel (1) in the absence of either deliberate or unintentional misrepresentation of facts (p. 496 2nd col.); or (2) if, notwithstanding the presence of such misrepresentation, the Commissioner knew the truth from other sources, or ought to have known the truth* (p. 495 2nd col.).

The taxpayer in the *Ross* case had failed to report income in the year received, apparently because he thought he was not required to return his salary accruals until they were actually withdrawn by him. It turned out that, although he reported his income on a cash instead of an accrual basis, the law required him to report the salary credits as they accrued. So that, literally, his return, by failing to report his salary accruals, amounted to a factual, though silent, misrepresentation. In the case at bar, the fact of receipt of the stock was reported, but its value when issued, and not its appreciated value, was entered on the return. Thus, the return did inform the Commissioner of receipt of the stock, whereas the returns in the *Ross* case afforded no information at all with respect to the income in question there.

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*The court said: "Nor probably even when he ought to have known the truth."

It is true, of course, that the value of the Reagan shares at any given time was a question of fact and not of law, but the mistake of law on the part of the taxpayer (Group No. 1 Oil Corporation) lies not in the determination of the actual value of the shares, but in the taxpayer's misconception of its obligation to report and pay tax on that value in 1927.

The taxpayer, as did all the other holders of interests in the 49 per cent of the Reagan stock, believed that as a matter of law the shares were not taxable in 1927, but in 1924 when they had only a nominal value. This is challenged in a footnote to Respondent's brief, where it is said, "The record does not show that the taxpayer contended that the stock constituted income in 1924." (Respondent's Brief 9). That statement fails to give effect to the entire record. The taxpayer's officers, attorneys and agents, who were also the officers, attorneys and agents, respectively, of its affiliates, Group No. 1 Oil Corporation and Texon Oil & Land Company of Texas, filed numerous protests, briefs, claims, and arguments in behalf of those taxpayers, asserting that the stock was received in 1924 and not in 1927.* If, by insulating these affiliated corporations against each other by iron curtains instead of veils, it is found to be literally true that Group No. 2 Oil Corporation, *qua* taxpayer, did not contend that the stock constituted income in 1924, it is nevertheless so just because the Government did not then propose to make an assess-

*Group No. 1's protest (Ex. 1-I R. 137-140), adopted by Texon (Ex. 1-J R. 141-143), Group No. 1's brief supporting claim for refund (Ex. 1-N R. 153-160), adopted by Texon (Ex. 1-M R. 150-152), and the pleadings in the suits filed by Group No. 1 and Texon (Exs. 1-O and 1-P R. 183 and 195) show how consistently it was contended that the Reagan stock was income in 1924 and not in 1927.

ment against the taxpayer. Nor can it be gainsaid that the taxpayer's position with respect to taxability of the stock then was exactly the same as the position of its affiliates, because they all expressed themselves and acted through the same officers, attorneys and agents; and if an assessment had been proposed against the taxpayer, those same officers, agents and attorneys would have made the same contention in the taxpayer's behalf.

If there were no explanatory circumstances disclosed in the record, any one with a fair acquaintance with the practices of corporate taxpayers and the Bureau of Internal Revenue would assume, nevertheless, that with respect to that stock the 1927 return was a mere token or advisory one; that the taxpayer, for some reason, believed that the stock was not legally taxable as income in that year. Its nominal value in 1924 had increased by 1927 to a very large amount, but it still had not been appraised. The entry on the return informed the Commissioner that the stock had been received. There is no record that it had been returned in any prior year.

It could well have been that in 1924 the owners believed that, because of the escrow provided for in the contracts, the stock was not then taxable income and they therefore did not then report it, and that in 1927 they believed that it was returnable in 1924*, and, desiring that the Commissioner be informed of the transaction, they reported the stock on their 1927 returns, but at no value or a nominal value.

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*The earliest record of a positive position assumed by them is the protests of the proposed 1927 assessments, and they there contended the stock was income in 1924. (Group No. 1's protest, Ex. 1-I, R. 137, 138; Texon's Protest, Ex. 1-J, R. 141-143).

The foregoing is not mere speculation. It is to be remembered that the transactions here involved took place some 23 to 25 years ago. Respondent, by his plea of estoppel, has created the necessity for reviewing, and the justification for rationalizing, those ancient events and actions, consideration of which would otherwise have been long since outlawed. The burden is on him to prove the taxpayer had no plausible reason for its action, that it misrepresented the facts and thereby misled the Commissioner. In the absence of any evidence, it is to be assumed that the taxpayer acted honestly and intelligently and in accordance with its understanding of the law.

It may be suggested that if the taxpayers thought in 1927 that the shares should have been taxed in 1924, they could have filed amended returns for 1924. The answer is, there does not appear to have ever been any law providing for amended returns for the purpose of correcting errors in former years, even though the Commissioner in some instances may have permitted the filing of such; and, besides, no tax would have been due for 1924, for the value of the stock still would have been $1.00.

The taxpayer's action in returning the stock for only $1.00 in 1927 was entirely consistent with honesty of purpose. The 49 per cent of the stock had been issued to the taxpayer and its affiliates and Big Lake Oil Company almost three years prior to 1927. It had no value when issued. Although placed in escrow, it could not be recalled by the other party to the contract. It was escrowed only until it could be divided among the owners. As a group they owned it all from the day that Reagan was organized. Even at this late day no one can dispute the fact that

there was then a real and plausible doubt as to whether the Reagan shares constituted taxable income to its recipients in the year 1927 rather than in the year 1924. That question was the subject of three litigations.* In none of the opinions is there a suggestion that the taxpayers did not make the contention in good faith.

But even if the nominal value given to the shares in the 1927 return be looked upon as a misrepresentation of fact, it avails Respondent nothing on his plea of estoppel, because the record teems with evidence of audits and other proceedings by the Government appraising and reporting the value of the stock before the end of the year, 1928, and by the assessment and enforcement of assessments, based on such value, against the taxpayer's affiliates, who received their shares at the same time and under the same contracts and circumstances as taxpayer received its shares.

Even in the meager discussion of the facts in the opinion of the Court of Appeals, that court found it to be true that the Commissioner knew the value of the shares through his investigation of taxpayer's affiliated companies. With that knowledge and the return itself before him, he had all the information he needed. He knew the taxpayer had received the stock and had not returned its correct value.

Respondent seems to attach importance to the finding of the trial court that the Commissioner did not audit the taxpayer because its return reflected a net loss. If he was "scared off" by a reported net loss of only $39,133.97

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*Big Lake Oil Co's case, 34 BTA 1003, 95 Fed. 2d 573 (3 Cir. 1938); Texon Oil & Land Co's case, U. S. Tax Cases Vol. 39-2 p. 10,576 (Dist. Ct.), 115 Fed. 2d 647 (5 Cir. 1940); Group No. 2 Oil Co's Case, R. 183-198 (Settled—not appealed).

on the 1927 return, he was even less self-reliant then than he was in the *Ross* case. A grade school child could have discovered that 544 shares of stock at $244.31 per share would have produced income of $132,904.64, which sum, minus the $1.00 already returned, if added to the return, would have converted the loss into a gain of $93,669.67—a not inconsiderable revenue producing sum, and all the result of recomputing a single item.

But the finding in question is immaterial because it destroys itself. It is that the Commissioner did not examine the return because it showed a loss. He could not have known that the return showed a loss without having examined it. Without having examined it, he could not honestly claim that he had been misled by it; but, for the purposes at hand, knowledge of what it contained is imputed to him whether he examined it or not. It must be assumed that he did examine the return and that he saw the Reagan stock returned at $1.00, while at the same time knowing from his own investigation of the entire transaction and his own appraisal of the shares that the taxpayer's 544 shares were then worth in excess of $132,000. It is the point of MR. JUSTICE FRANKFURTER's decision in the *Ross* case that from that time on the Commissioner was "on his own." In 1928 he knew all, or should have known all.

It is, to say the least, unconvincing for the Respondent to argue that in 1928, when the Commissioner of Internal Revenue was engaged in auditing and checking the records of the transactions and making the demands against the taxpayer's affiliates, the taxpayer did not "officially or pointedly" inform the Commissioner that the same situation

existed with respect to its 1927 income. Surely the taxpayer was under no duty to invite an assessment against itself of a tax which it then in good faith did not believe it owed.

The trial court's finding that the taxpayer did not *"officially and pointedly"* inform the Commissioner in 1927 that it was in the same boat with its affiliates was made, of course, on the theory that the Commissioner is not bound unless he ascertained the facts from the taxpayer, but it goes further than did the court of appeals and inferentially holds that the taxpayer could not absolve himself by telling the Commissioner privately. Nor, says the District Court, in effect, can the Commissioner take a hint. You must make it pointed.

On the plea of estoppel the taxpayer did not have the burden of showing that the Commissioner was fully informed of the facts. Rather, the burden was on the Respondent to show that the Commissioner was not informed from any source. He made no attempt, however, to discharge that burden. The taxpayer, on the other hand, presented indisputable evidence that the Commissioner was fully informed as the result of his audits and examinations of the taxpayer's affiliates, and the trial court found, in short, that the Commissioner knew that the taxpayer had received the stock in question and that it had received it under the same circumstances as the affiliates had received theirs.

Under the facts shown in the record and found by the trial court, it was the Commissioner's duty to make up his

own mind as to the taxability of the taxpayer's income represented by the shares received in 1927.

Conflict with McEachern v. Rose, 302 U. S. 56

In trying to distinguish this case from *McEachern* v. *Rose,* Respondent attaches too much importance to labels of defenses. It is agreed that the defense of recoupment was disallowed in *McEachern* v. *Rose,* but argued that the decision below in this case does not rest upon the right of recoupment (Respondent's Brief 7), but upon what may be conveniently called "quasi estoppel" (Respondent's Brief 6). Possibly that is the same thing that Judge Hutchinson called "want of equity and good conscience" in the Court of Appeal's opinion in *McEachern* v. *Rose.* This Court put no brand on the defense in that suit at all, except to hold that it was not sufficient in view of the statutes which precluded the Government from taking any benefit from a taxpayer's overpayment by crediting it against an unpaid tax whose payment had been barred by limitation.

In *American Light & Traction Company* v. *Harrison,* 142 Fed. 2d 639 (7 Cir. 1944) the Court lumped all such defenses into the same category, saying:

> "In the *McEachern* case, as here, the overassessments for subsequent years resulted from a mistaken treatment of a transaction in an ealier year. There, as here, the barred deficiency for the earlier year exceeded the admitted overpayments for the later years. There, as here, whether it be called recoupment, offset, equitable credit, or some other term, the Govern-

ment's contention was the same, and it is clear that the difference between the defense urged there and that urged here is purely verbal."

Respondent seems to disavow his pleas of estoppel and recoupment lodged in the trial court, and rely now upon some theory of election. It is urged that the court below has simply held, without more, that "since the taxpayer in 1927 reported the Reagan stock as income at the value of $1.00, it may not change its position and use a higher basis for determining gain or loss on the sale of stock in 1941" (Respondent's Brief 7). If this is all, the complete answer is found in MR. JUSTICE FRANKFURTER's decision in the *Ross* case, where he discussed "election" and "quasi estoppel" (169 Fed. 2d, pp. 493-495).

In a further effort to differentiate this case from *McEachern* v. *Rose*, it is said that in the present case no *admitted* overpayment is involved (Respondent's Brief 7). It is difficult to see how it could make any difference whether the overpayment is admitted or not admitted. Any plea that amounts to a plea of estoppel, by whatever name it is called, in answer to a suit for recovery of an overpayment of taxes admits the overpayment, but resists the recovery of it for some underlying reason. Such a plea is by its very nature one of confession and avoidance.

In the case here, the statute fixes the taxpayer's basis for determining gain or loss on the sale of the stock at its value when received in 1927. (Revenue Code, Sections 111 and 112). That basis cannot be changed by any act of the parties. In obedience to the law, the trial court found that the true basis of the 250 shares of stock was $244.31 per

share, or $61,078.68 (Finding 16, R. 38).* Taxpayer sold the 250 shares for $3,750, a net loss of $57,328.68. The Commissioner disallowed the loss, and required the taxpayer to recompute and pay tax as on a gain of $61,078.68 less $1.00. For the year 1941 there has obviously been an overpayment of tax. The claim for refund was made for an overpayment; this suit is for an overpayment; and the answer in effect admitted the overpayment, but said the taxpayer was estopped because it owed unpaid tax on the stock for 1927. Whether or not the Respondent admits liability for the overpayment would appear to be wholly immaterial insofar as differences or similarities between this case and the *McEachern* case are concerned. If the taxpayer ultimately recovers, the judgment will establish the overpayment, and that the Government cannot credit it against a barred 1927 tax liability.

As a part of his "Statement" Respondent has repeated a sentence of the trial court's 19th finding (R. 38) to the effect that the taxpayer failed to establish "that it did not during the calendar year 1941 earn normal and surtax net income in the amount of $54,968.06 and excess profits tax net income in the amount of $60,547.83, as determined by the Commissioner of Internal Revenue." That is an assertion that, even though the taxpayer was right in its contention with respect to the statute of limitation, nevertheless it was possible that the taxpayer had other net earnings in 1941, which, regardless of the stock transaction, justified the assessment of the tax.

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*In paraphrasing the 16th finding of the trial court (Respondent's bf. 5), the Respondent failed to mention the fact that the trial court found as a fact that this was the taxpayer's true basis.

In view of the Commissioner's 90-day letter (R. 253), upon which the assessment was made, and which set forth the taxpayer's income, deductions, and whole liability for that year, that contention and finding is wholly unwarranted. That letter shows that the net adjustment to taxpayer's income in the amount of $61,078.68 was due entirely to the stock transaction [R. 259, subd. (f) and 265, subd. (b)]. There is no presumption that the taxpayer owed the Government on account of any transaction or income that was never mentioned in the 90-day letter or in the assessment made.

Respectfully submitted,

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